American stock market crash of 2000-2002 is a recurrence in the real estate market. Americans love bubbles. Right on the heels of the 2000-2002 stock market collapse, we find ourselves faced with a similar situation in the real estate market.

As interest rates fell to 40-year lows and investors searched for alternatives to stocks, real estate became the next great opportunity to make a quick buck. Shortsighted homeowners tapped into home equity loans to purchase everything from flat screen TV’s to second homes. Others used these newly created home piggy banks to speculate in more real estate and/or the securities markets. This significantly increased the demand for mortgage loans, leading to a predictable increase in supply of these loans from banks and mortgage companies; increased competition among these lenders (resulting in very “creative” lending practices); and the requisite participation by the Wall Street financial packagers to keep the whole party humming along as long as substantial profits were to be made.

The party ended and the hangover ensued when interest rates started to rise and home sales stalled. Over-extended speculators were forced to sell into a market with few buyers and many borrowers couldn’t afford their higher mortgage payments. Default rates began to rise and investors in the many new Wall Street mortgage-based securities discovered that they miscalculated (and were often mislead about) the risk in these securities. Liquidity dried up, prices fell, and a general pessimism has once again infected the worldwide economy and global securities markets.

The Blame Game

Now we’re in the phase of finding “villains” and the mass media, general public, business people, and politicians are falling over each other to assign blame. Each has a different boogeyman, of course. Business people and the financial press tend to blame the Federal Reserve. After all, if they hadn’t reduced interest rates to such low levels, none of this would have happened! Never mind that responsible first-time homebuyers took advantage of an opportunity of a lifetime; or that the market (not the Fed) really “sets” interest rates (see chart on back); or that

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business people have an ethical obligation to fully disclose risks and costs to buyers of their products or services.

Politicians, depending on what side of the aisle they reside, blame either “greedy corporations” for selling mortgages to people who couldn’t afford them (with little or no recognition of personal responsibility) or the people themselves for their greed, ignorance, and shortsightedness (with little or no recognition of the many illegal and unethical practices of the mortgage business). The general public seldom blames themselves for their greed and ignorance and instead looks increasingly toward others to make decisions for them.

Personally, I believe most of the blame for the subprime mortgage debacle lies with two groups: certain borrowers and mortgage lenders. The first over-extended themselves to fund a “keep up with the Jones” lifestyle and to speculate in the real estate market. The second engaged in shoddy and unethical business practices knowing full well that many of their customers could not afford the loans. They also knew that Wall Street would package the mortgages in a way that would obscure and spread the true risks of these loans to investors.

Secondarily, I blame the Wall Street types who packaged and sold the securities to unwitting investors and the money managers who loaded up their mutual funds or separate accounts with them to “boost” returns without understanding their risks.

In the end, however, the blame game only helps our clients if those who broke laws or engaged in unethical behavior are held accountable under current laws, or where absolutely necessary, under new laws designed to prevent obvious abuses. This might put a productive damper on both the upside and downside of these kinds of cycles. But greed and ignorance will always be a part of investing and the American culture. And aggressive product development and marketing will always be part of the Wall Street culture.

**Now What?**
In an article to be published in *American Banker*, William M. Isaac, the former Chairman of the FDIC, provides a perspective on the subprime mess. He begins by pointing out that the problem is not being caused by an economic downturn. On the contrary, after the stock market collapse and the turmoil caused by the 9/11 terrorist attacks in 2001-2002, interest rates fell and real estate appeared to be a safe haven. The real estate market overheated due to speculation and was bound to correct at some point. Interest rates rose and housing sales slumped, starting a chain reaction that has resulted in the current mess.

In the past, problems with loans such as these were reflected on bank financial statements and, due to banking regulations, we were able to gauge the extent of problems fairly quickly and easily. Today, these mortgage loans are packaged into trusts, and securities representing ownership of the trusts are sold to investors such as pension funds, mutual funds, hedge funds, and insurance companies all over the world. So the good news is that the problems don’t appear to have affected the banking system to a significant degree and the risks are spread broadly among investors worldwide. It’s estimated that the total of sub-prime loans outstanding is about $1.2 trillion. A high rate of loss on these kinds of loans is 15% pretax, amounting to a loss of $186 billion spread over time among investors all over the world—about the impact of a 1% decline in the U.S. stock market. Consider this in the context of the response to the Fed's recent half-point cut in its target short-term lending rate: the Dow soared 2.5% in one day!

That this move was a “surprise” to investors reminds me of Phil Jonckheer’s article in last month’s *Asset Class* (“What’s Correct?”). His statement, “All too often, the long-term return on a portfolio is not influenced by what the market does; it’s affected by what the investor does to the investments,” bears repeating.